

Palau: Background and Current Issues

Background

- Palau is one of three Pacific island nations that has signed a Compact of Free Association with the U.S.
- The three Freely Associated States (FAS) span the Pacific from Hawaii to Indonesia and have a combined Exclusive Economic Zone (EEZ) larger than the 48 contiguous States. Palau, with an EEZ the size of Texas, is the closest FAS to Asia.
- Military commanders say that Palau is more strategically vital to the U.S. now than it has ever been. The nation has just become the site of the Defense Department's new, over-the-horizon early-warning radar system.
- The U.S. took Palau from Japan in World War II and then administered the islands as a territory on behalf of the United Nations to eventually be made independent. Later, not wanting to lose strategic control of the area, the U.S. extended Federal domestic programs and encouraged the unique free association relationship.
- Under the US-Palau Compact, the U.S. has exclusive access to Palau's land, water and air. The U.S. may overrule Palau government policies deemed inconsistent with U.S. defense policy (the "defense veto") and may deny access to Palau by military forces of any other nation, most notably China (the "right of strategic denial").
- The U.S. also grants economic aid to the FAS on a multi-year basis, provides Federal domestic programs, and permits visa-free travel for the tiny FAS populations. Twenty thousand people live in Palau. Palau's Compact expires in FY24. Compacts with the other two FAS (Republic of the Marshall Islands and Federal States of Micronesia) expire in 2023.
- In 2019, U.S. Indo-Pacific Commander Philip Davidson testified before Congress that the FAS were being subjected to "the pernicious use of Beijing's economic leverage" in an attempt to distance them from the U.S. and Taiwan.
- A 2019 [RAND report](#) for the Secretary of Defense advised that a failure of the U.S. to provide needed economic assistance "could come at the expense of the defense and foreign policy interests of the United States."
- President Trump met with the three presidents of the FAS in 2019. Secretary of State Mike Pompeo then visited the islands as follow up to announce the commencement of negotiations to extend the Compacts. In 2020, however, the talks stalled amid disagreement over continued aid to the FAS.
- In March of 2022, President Biden, responding to inquiries from Members of Congress of both parties, named Ambassador Joseph Yun as Special Presidential Envoy for Compact Negotiations to revive the talks.

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Current Issues

- **Covid Revenue Loss Debt Relief**– With a private sector dependent on tourism and foreign fishing, Palau’s economy has shrunk 28% due to the pandemic and China banning it as a tourism destination. Palau is the only U.S.-affiliated jurisdiction, however, to get loans instead of grants for Covid revenue losses.

President Whipps got the FY22 budget cut 10% and major tax, Social Security, and other self-help reforms, but Palau still faces an \$20 million deficit this year and a deficit in FY23.

The Asian Development Bank gave the other FAS grants because of lower pre-Covid incomes. It has loaned Palau \$60 million already and will loan another \$30 million for FYs 22 & 23. Palau needs \$90 million in COVID debt relief.

Palau borrowed as little as it could to prevent massive unemployment and a sharp reduction in disposable income. Economists consider such borrowing justifiable in a cyclical fiscal crisis, but the debt will have long-lasting negative impacts on the islands’ economy and budget.

If no debt relief is provided, Palau’s people will suffer from reduced government services and programs and its economy will suffer from that and a reduced ability to meet infrastructure needs.

- **Blue Prosperity Plan** - \$2.6 million of the deficit is due to Palau banning fishing in 80% of its waters. More fishing could generate more revenue, including from China, but The Nature Conservancy and the Biden Administration back a plan under which philanthropies would give Palau \$18.8 million over three years to not increase fishing and develop alternative marine resource alternatives. \$16 million is needed from the U.S. for the main harbor and aquaculture. The investments would generate the \$2.6 million a year after the third year.